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EGYPTIAN ECONOMY APPROACHING ANOTHER CRISIS

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EGYPTIAN ECONOMY APPROACHING ANOTHER CRISIS

Egypt's mounting financial difficulties again are coming to a head, and some changes in economic policy probably will occur within the next few months. The impending crisis has been postponed for several years, but another easy reprieve seems unlikely. An austerity program announced last winter was never fully implemented, the foreign trade gap is growing, overdue debts are mounting rapidly, and renewed pleas for debt relief are falling on deaf ears throughout the world.

An International Monetary Fund (IMF) team is currently in Cairo for talks that may set the stage for currency devaluation and a serious austerity program. Otherwise Egypt will face a complete loss of world confidence in its ability to service its foreign debt. An IMF-sponsored program would be of limited duration, permitting Egypt to renegotiate pressing debts and perhaps leaving the door open for eventual resumption of overspending.

The Communist countries seem to be encouraging Cairo to undertake the financial reforms recommended by Western creditors and institutions.

Indecision in Cairo

Both President Nasir and Prime Minister Muhyi al-Din repeatedly have stressed the need for cutting consumption, reducing imports, and facing the economic facts. On 1 December, Muhyi al-Din announced a series of austerity measures that were widely commended as realistic steps to reduce the threat of economic instability. In the intervening nine months, however, only minimal action has been taken, and the situation has been greatly aggravated by hesitancy and indecision. Some sort

of jockeying for power between Muhyi al-Din and more radical factions also may be involved. The prime minister obviously recognizes the problems and understands what should be done but thus far has been unable to take resolute action, perhaps because Nasir has not given him full support.

Egypt's financial difficulties stem from three inter-related factors. Excess imports and other foreign expenditures, financed by increasing reliance on short-term and medium-term borrowing, have brought about a

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serious and continuing shortage of foreign exchange. Government policies have failed to produce an expected shift in total expenditures away from consumption toward domestic savings and investment. Also, the growth of population has greatly exceeded the level anticipated. Because Nasir always has chosen to seek immediate political or ideological gains before long-term economic improvements, economic matters have been ignored as long as possible.

Muhyi al-Din's austerity program, announced only two months after he took office, was designed to meet these problems. The major points were selective price and tax increases, cuts in government expenditures, and a new emphasis on population control measures. The attack on rising consumption involved both higher prices to reduce disposable income, and higher customs duties to reinforce restrictions on consumer imports. Concurrently, the government announced plans for a free zone at Port Said, and official pronouncements indicated a new and more welcoming attitude toward private foreign investment. Shortly thereafter, the second stage of the nation's development plan was extended from five to seven years, thus reducing the annual requirement for foreign exchange and bringing the revised plan somewhat closer to the country's production capabilities.

Although the regime has a history of backing away from un-

pleasant decisions, it appeared serious about the new price and tax policies. In the previous few years, several austerity measures were introduced, then quickly withdrawn when resistance mounted. Stringent import controls, meat rationing, and other measures adopted in the fall of 1964, however, were maintained. Moreover, Nasir took pains to associate himself with the new program and repeatedly stressed the urgent need for austerity.

Progress in 1960-64

In a sense, Egypt is a victim of its own success. Its over-all record of economic growth since becoming a republic in 1952 has been good, and the 1960-64 period, in particular, was marked by substantial progress. For the first time in the twentieth century, economic expansion outpaced population growth. During the period of the first development plan (July 1960 - June 1965), gross domestic product increased at an average annual rate of almost six percent, whereas population increased at a rate of almost three percent. Gains in agricultural output kept up with population growth, while industrial production expanded by about nine percent a year.

Together, economic growth and welfare programs brought about a more equitable distribution of income and social benefits than in prerevolutionary times. Certain aspects of this growth were harmful, notably

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employment of unneeded bureaucrats and production workers and investment of scarce funds in prestigious but unprofitable projects. Everything considered, however, the accomplishments of the Egyptian economy are greater than those of most other underdeveloped countries.

Progress, nevertheless, has been expensive. Spending in excess of current income began under King Farouk and accelerated under the Nasir regime, as mounting debts testify. Gold and foreign exchange holdings sank from \$1.4 billion in 1948 to \$972 million at the end of 1951, Farouk's last full year in power. By the early 1960s, they had been depleted to little over \$200 million, and Cairo was forced to resort to high-cost commercial borrowing to finance imports needed to maintain the pace of growth. As current expenditures abroad came to exceed current receipts by almost \$300 million annually, foreign debt service claimed a third of the foreign exchange available each year. Large chunks of foreign exchange were spent to build and support industries that may never break even.

As the foreign exchange position deteriorated, strains in the domestic economy also became more severe. The regime spent heavily to build hospitals and schools, to introduce new welfare programs, and to expand the armed forces. A cumbersome bureaucracy was created to run newly nationalized enterprises. Government

expenditures exceeded revenues by progressively larger amounts, and deficits were covered by borrowing from domestic banks. The resulting increase in the money supply created inflationary pressures. Controlled domestic prices did not adjust to changes in demand, consumer imports rose, and a black market developed. Consumption grew more rapidly than production, absorbing domestic funds needed for investment. Moreover, the over-ambitious development plan called for investment funds in excess of the combined amounts available from domestic and foreign sources.

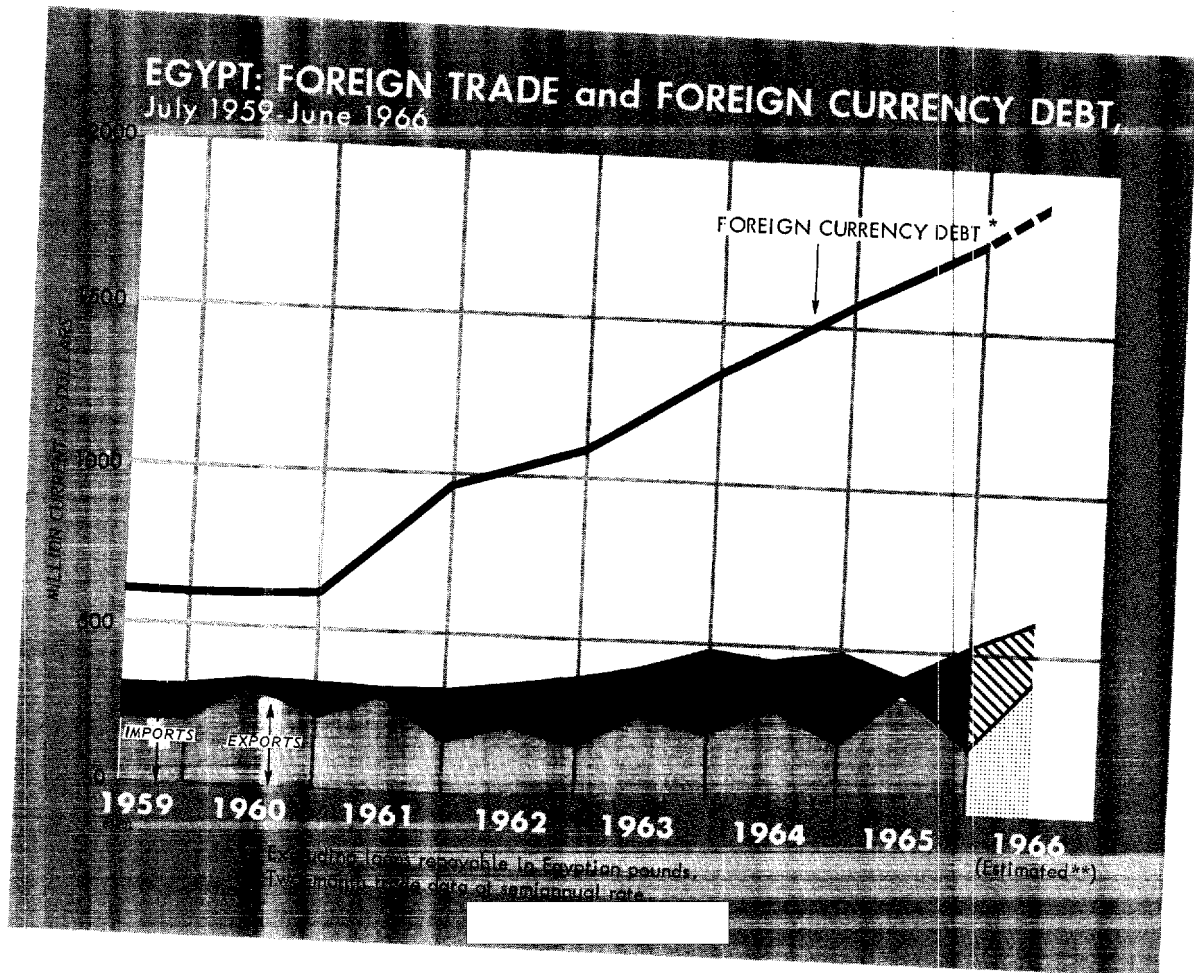
By late 1964, new sources of credit were nonexistent, and a number of stopgaps were adopted. These measures, added to the strains created by the forced pace of growth, made 1965 an especially disappointing year and led to the antagonizing reappraisal undertaken by the Muhyi al-Din government.

Slowdown and Austerity

The fiscal year which ended on 30 June 1965 differed from the preceding years in a number of important respects. After two successive years in which annual growth approached eight percent, the FY-1965 increase was less than five percent. The lag in growth stemmed partly from the austerity program but was aggravated by bureaucratic errors. The major factor was an expansion of industrial output by only four percent--less than

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half the annual average of the preceding four years--primarily because of shortages of imported raw materials, intermediate products, and spare parts resulting from stringent import controls imposed in 1964 to combat the foreign exchange drain. Construction, which in preceding years enjoyed a considerable speculative boom, actually declined. Expansion of the services sector, which includes the huge bureaucracy, also slowed somewhat from the previous year. Of the major economic sectors, only agriculture enjoyed a relatively good year.

Nevertheless, improvements were registered in some basic areas. For the first time in years, the foreign trade gap was narrowed--from \$407 million in FY 1964 to \$303 million in FY 1965--and net borrowing from abroad was reduced. The over-all balance-of-payments deficit fell from \$89 million to \$28 million, with improvements registered in both current and capital accounts. Consumption, including defense, increased only slightly in absolute terms, absorbing a smaller share of total output than in each of the preceding three years. Consequently, a greater portion of total output was available for investment. Moreover, with government borrowing from domestic banks cut by almost 80 percent, the money supply increased only slightly.

Deterioration in 1966

In spite of the brave-sounding pronouncements of December,

available data suggest that the gains made in 1965 are being lost in 1966. The need for greater austerity is clear, and the reasons for slowing the tempo of economic expansion are compelling, but Cairo apparently was jarred by the 1965 slowdown and has reverted to its earlier ways. The trade gap is growing again, the government has stepped up its borrowing from domestic banks, gold and foreign exchange holdings are at an all-time low, and government expenditures are rising. Despite increased spending, growth of the economy in FY 1966 probably remained at or below the low level of FY 1965.

The foreign exchange shortage is more acute than ever. The trade deficit for the first eight months of FY 1966--through February, the latest month for which figures are available--was almost 20 percent larger than for the same period of the previous year and ran ahead of the record level of FY 1964. In the 12-month period ending 30 April, gold and foreign exchange holdings of the Central Bank dropped \$25 million to an all-time low of \$170 million. Foreign exchange reserves in cash stood at \$23 million in mid-July, a time when they are usually near their yearly peak. This was \$5 million below the July 1965 level. The bilateral trade debt, primarily to Communist countries, totaled \$198 million in mid-July, --an increase of \$67 million in 12 months, despite unusually heavy exports to bilateral trading partners during the period.

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On the domestic front, inflation has been given further impetus by increased deficit financing of larger government expenditures. During the first 11 months of FY 1966, the government's debt to domestic banks increased by over \$313 million--or \$5 for every \$1 increase in the same period of the previous year.

Last December the government told the IMF that it intended to decrease total current expenditure substantially and cut cost-of-living subsidies by \$16 million from the original FY-1966 budget figure of \$80 million. The cuts were to take effect immediately and be continued into subsequent years. Recently released figures on the FY-1967 budget, however, show no such change. Current expenditures exceed the original FY-1966 budget estimates by \$165 million. Cost-of-living subsidies, instead of falling, are scheduled to rise by \$3 million. Although flour prices were raised and the size of a loaf of bread was reduced, wheat and flour subsidies alone are expected to increase by over \$4 million to almost \$36 million.

The 1967 budget envisages revenues higher by almost \$220 million, primarily as a result of the price and tax changes made last December. Increased expenditures, however, are due to absorb all but \$10 million of the anticipated revenue gain. Thus, expenditures are being transferred from private to pub-

lic consumption, rather than from consumption to investment.

Delay and indecision have interfered with earning opportunities as well as with internal fiscal reform. A promising new oil field in the Gulf of Suez remained inactive for many months pending final agreement between Cairo and the American concessionaire in June.

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The new field probably will not start producing until early 1967. A further loss probably resulted from delay in signing a new pact with ENI, the Italian company that is a partner in exploitation of other Egyptian fields. ENI had delayed expansion plans during the several months of negotiations. In both cases the Egyptians forfeited current income in order to improve terms pertaining to future debt payments. Consequently, the 1965 increase in Egyptian crude output was the smallest in years and crude export earnings failed to rise.

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Even the Suez Canal, symbol of Egypt's independence and success, has been affected by the desperate search for financial relief. Canal revenues have continued to grow and totaled about \$209 million in FY 1966, supposedly all in hard currency. In fact, at least \$19

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million and possibly more than \$24 million annually is in effect mortgaged to pay for current purchases or debt obligations. During PL-480 negotiations in late 1965, Cairo agreed to let US Government ships pay from accumulated Egyptian pounds the equivalent of some \$200,000 in canal fees during calendar 1966. Compensation for nationalization of Shell and British Petroleum interests is being paid partly by forgiveness of \$2.3 million in canal tolls annually for the next eight years.

In view of Egypt's extreme sensitivity about any diversion or commitment of canal receipts, these arrangements are the clearest possible indication of the severity of the current financial crisis. In its anxiety to increase current receipts, Egypt also may be reducing the canal's earning potential by enacting the third small fee increase in three years. Gulf Oil recently decided to rely exclusively on giant tankers that will avoid the canal, and other oil companies reportedly are considering similar moves.

Fruitless Search for Relief

For the third time in as many years, Egyptian teams have

tried to arrange postponements of external debt repayment, but their efforts have met with little success. For the past several years, short-term bank loans outstanding have totaled \$200 million or more. On these debts, interest charges alone cost over \$15 million annually, and constant refinancing of repayments due on the principal has been necessary. Perhaps \$100 million is now overdue on Western short-term loans. The most recent Egyptian proposal was to pay all amounts overdue through last October and to refinance amounts that were due in the eight-month period from November 1965 through June 1966.

Of the countries approached, only Italy acquiesced. In conjunction with ENI's new agreement with Egypt, Italy has provided \$31 million in new long-term loans, extended \$10 million in new export credits, and eased the repayment schedule on \$74 million in outstanding loans.

British banks have said they will extend no new credits while repayments are overdue, and American banks have been unresponsive to requests for a new moratorium. Both London and Washington have urged Cairo to work out a multilateral refinancing program under the aegis of the IMF. Bonn also refused to discuss any extension of repayments on government-guaranteed debts except as

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part of a multilateral program, although commercial bankers in West Germany apparently agreed to let Egypt remain about six months in arrears on some \$5 million in short-term obligations.

Time for Decision

Egypt now has no prospect of securing major financial relief abroad. Consequently, changes in economic policy appear inevitable and not far distant. Nasir rapidly is being backed into a corner and must make some choices or they may be forced upon him. The next two months probably will set the tone for the coming year or two.

The short-term economic future of Egypt hinges on the results of an IMF mission currently in Cairo. Fund officials viewed last December's austerity measures with considerable approval, but only part of the promised program was implemented. Consequently, the IMF now believes devaluation of the Egyptian pound is inescapable. The Egyptians earlier refused to consider such a move and contacts ceased for several months. In late July, however, the IMF was advised that Cairo was prepared to accept its recommendations "in principle" but wanted to discuss the extent and details of the suggested program. If discussions lead to devaluation, Egypt is in for a period of greater austerity. In such circumstances, however, Western creditors probably will be willing to extend a helping hand.

While devaluation is politically unpalatable for the regime, it offers the best hope for economic progress in the long run.

A new austerity program might be only a temporary expedient. Any stabilization plan worked out with the IMF probably would require Egyptian compliance with restrictions on imports, domestic credit, and consumption spending for up to two years. In return, Egypt would receive additional financing from the Fund, and an agreement with the IMF would enable Cairo to renegotiate debt obligations to bankers and governments throughout the free world. Once the immediate pressure has been relieved, Nasir could resume overspending abroad and inflationary policies at home and could continue such tactics until credit again was exhausted.

If Cairo proves unwilling to make the necessary adjustments, the next 12 months may bring even greater delays in debt payment, repeated refusals of new requests for credit, a foreign rescue operation, or some combination. If Western bankers continue unwilling to increase credit lines and all the major nations deny renewed pleas for financial assistance, Egypt will lack funds to purchase needed foodstuffs, procure industrial goods for its factories, and make even partial payments on current and overdue debts. Food supplies now on order will be consumed by January or February when foreign

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currency reserves usually reach their yearly low. To date, the Nasir regime has been conscientious, if sometimes slow, about paying its foreign debts. Under any circumstances, Egypt will try to make at least token payments, because a unilateral suspension of debt repayment would be followed by immediate cessation of new commercial credit and would destroy any hope of economic progress in the next few years.

From all indications, the USSR is extremely reluctant to see Egypt lose Western assistance at this time. The Soviets have used several channels to urge the US to continue food shipments under PL 480 and say they have urged Egypt to remain on good terms with the West. The high cost of supporting the Cuban economy probably makes Moscow reluctant to assume a similar burden for Egypt. The possibility that the USSR might make the necessary outlays, however, cannot be dismissed out of hand.

Kuwait has provided Egypt with over \$200 million in cash support, as well as other assistance in the past several

years. Kuwaiti funds are not inexhaustible, however, and each new loan has faced greater opposition in the Kuwaiti parliament. Presumably Kuwait will hesitate to increase this assistance if Egypt fails to satisfy the demands of other free-world lending sources.

If Cairo chooses the path of austerity and reform, Prime Minister Muhyi al-Din appears to be the logical person to carry out the program. Because of his many pronouncements on the subject, his name already is associated with self-sacrifice, greater use of domestic resources, and increased emphasis on efficiency and saving. Political expediency, however, may inspire Nasir to make Muhyi al-Din a scapegoat for current failures and to turn to some new prime minister.

If, on the other hand, Egypt rejects austerity and elects to continue its present course, Muhyi al-Din would almost certainly be replaced. In these circumstances pro-Soviet former prime minister Ali Sabri would most likely be tapped to head the government again.

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(Prepared by the Office of Research and Reports)

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